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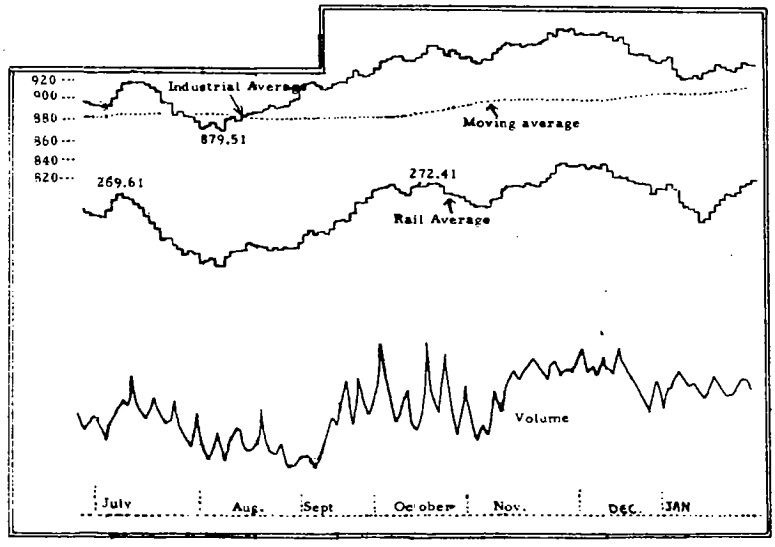
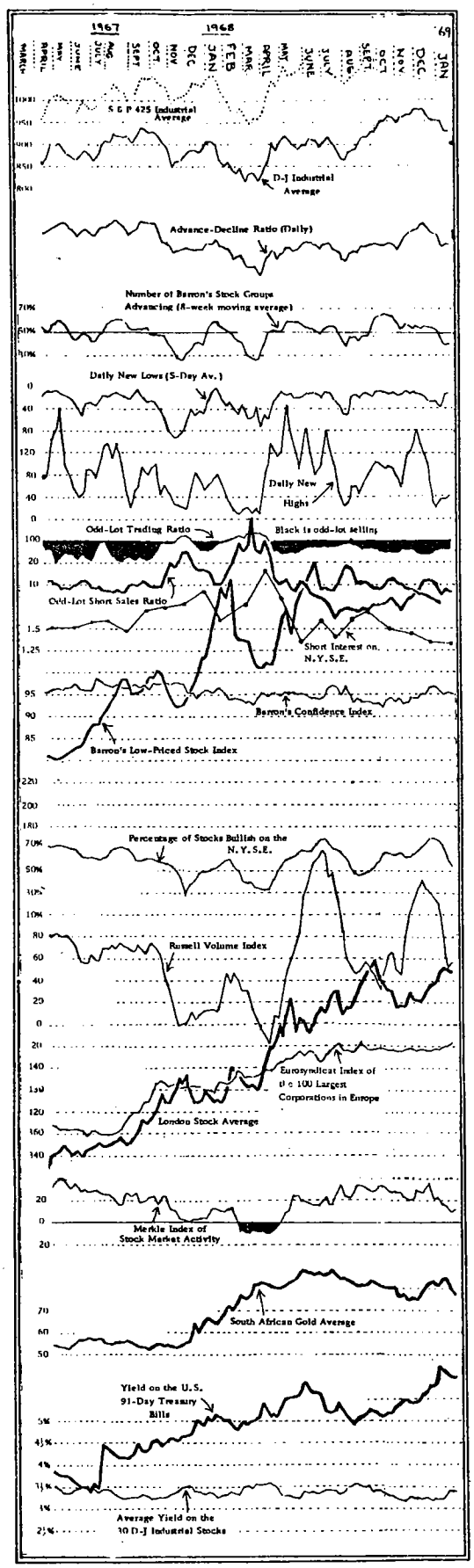
THE MARKET: One of the most interesting comments I have read this week was provided by Humphrey Neill of Contrary Opinion fame. Neill notes that at the time of the surtax debates, it was generally held that the additional tax would slow down the boom and hold back inflation. Those who assumed a contrary view were correct. No slowing down of either the economy or inflation followed the passage of the surtax.

"Next and more recently," adds Neill, "it has been commonly accepted that nothing will slow down the boom or moderate the inflation? How about this? My guess is that we shall shortly learn the boom will be retarded; in fact, there is a very good chance it will be stopped in its tracks. May well back up."

I tend to agree with Mr. Neill. The more so, of course, since I believe that we are still in a continuing (though highly deceptive) primary bear market, and we have been in such a bear market since February, 1966. No two bull or bear markets are ever the same, runs the old Wall Street adage, and this bear market is no exception. It has been three years since the 1966 bull market top, and no one has yet really felt the grip of the bear. In fact, the only testament to the bear's grip is the fact that for three years, despite galloping inflation and booming business conditions the D-J Industrial Average has persistently refused to better its 1966 high.

But sooner or later the bear forces must and will express themselves in recognizable fashion, and I feel that that time is drawing steadily closer. I hesitate to say this, but I feel that basically, the country is very suspicious and distrustful of Mr. Nixon. Nixon is not one to inspire trust or confidence from the public (never has been), and I believe that any economic downturn would fan that lingering mistrust into open resentment and fear. Nixon never was popular with the American people, but rather he gained the Presidency in large part as a protest against President Johnson. It was not that the public loved Nixon, it was that they wanted Johnson out.



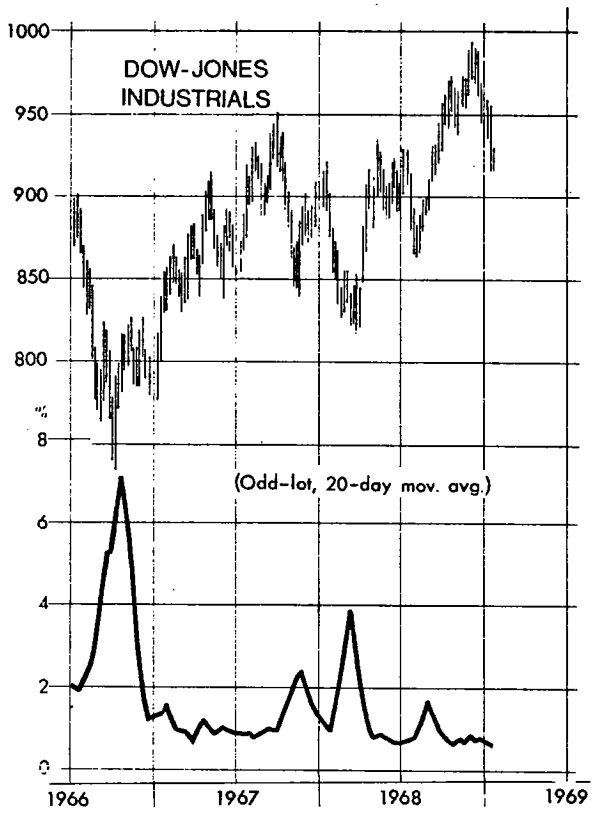

1967
1968
69
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Eurosyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Merkle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

Confidence is a very fragile thing. In times of adversity, it requires a man of Franklin Roosevelt's or Teddy Roosevelt's caliber to inspire it in the public. I do not believe that Nixon has that personal magnetism (and I am not talking about ability), and I feel that the American people could easily make Nixon the scapegoat if the economy turned down. This may seem a minor consideration to readers, but I consider it highly important regarding future psychology both on Wall Street and on Main Street.

Another factor worth considering is simply the effect of historically high interest rates. In another section of this Letter, I detail what happens to the cost of home-purchasing at 7.5% average mortgage rates, and already it is natable that the nation's biggest business, housing, is beginning to feel the effects of high rates. Car sales too are leveling off, while auto inventories are bulging in the neighborhood of 1 2/3 million cars, just short of the record set during the 1966 credit crunch.

The difference today and during 1966, as I see it, is the current unaccountable complacency. Perhaps this is best seen in the stock market itself, where we learn that the total N.Y.S.E. short position just dropped over 3 million shares in January. Although much of this may be due to selling against the box and normal January short covering, it is still an all-time record.

Even more significant to me is the complacency shown on the current market decline by the odd-lot short sellers. Here again a chart serves to put the situation into perspective (chart courtesy of the Holt Advisory service, 305 Madison Ave., N.Y.C.).



Note that over the past four years important bottoms have been accompanied by sizable increases in the odd-lot short sale index. This was true during the 1966 bottom, the late-1967 bottom, the later 1967 bottom and even during the sharp sell-off of 1968. Yet during 1969 this index has held remarkably near its lows of the past four years, despite all the downside market action of December and January. If the December low completes the decline, it will be the first time that a low has failed so utterly to stir up odd-lot short selling. The suggestion is that there will be new lows and much odd-lot shorting in the period ahead.

The Russell Volume Index (see composite page 1 chart) has dropped from a high of 137 recorded six weeks ago to last week's 51. This decline was brought on basically by a decline in buying volume while selling volume held steady at high levels. Actually, from our standpoint it makes little difference "how" this index drops, but I thought it was interesting that selling volume was so high, and that it continues high. Thus, any cessation in buying tends to send the market lower. This is not true in a market where selling pressure is low and buying subsides. In other words, with the large selling pressure in this market it is going to take continued heavy buying to hold it up or send it higher. As a rule, a drop of 86 points (such as the recent one) in the Russell Volume Index is followed by considerably more downside action in the market than has so far been seen.

INFLATE OR DEFLATE: The general consensus of informed opinion is that Mr. Nixon and his Administration are going to take a firm stand against inflation (or at least the rate of inflation which has characterized the Johnson years). Further, it is known that Mr. Nixon is sceptical of the school which allows high interest rates while coincidentally pumping up the money supply. Mr. Nixon's followers are much more apt to attempt to stabilize the money supply in their fight against inflation.

In his coming battle with inflation, two possibilities present themselves. The first is that the economy will contract, and that by producing some sort of an economic slowdown or recession Mr. Nixon will hold back the forces of inflation. Assuming Mr. Nixon is willing to tolerate a higher rate of unemployment (and many say that he will) it is doubtful whether he will also tolerate a recession. That remains to be seen.

However, assuming that Nixon will accept a "mild" recession (and assuming that the new Administration can produce the "kind" of recession they desire), a recession will mean a decline in Federal tax receipts. Few people are thinking along these lines, but a drop in corporate and personal tax receipts would put our Government in a vast financial bind. With

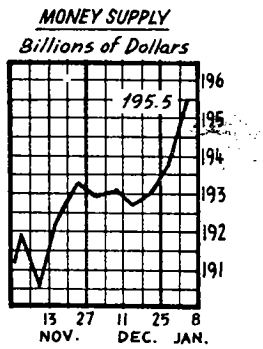
else can reverse the market and the economy at will. I believe that they can during a recession within a primary bull market. But my guess is that any recession now, within the framework of a primary bear market, will be impossible to stop until it has run its course.

Somehow, I am reminded of William Hamilton's last paragraph (October 25, 1929) in the Wall Street Journal: "Some time ago it was said in a Wall Street Journal editorial that if the stock market was compelled to deflate, as politicians seemed so earnestly to wish, they would shortly after,experience a deflation elsewhere which would be much less to their liking."

Ironically, in 1929 our politicians wanted the market to deflate although they were perfectly happy about the level of economic activity. Now, forty years later, the politicians want the economy to deflate, although nobody wants to hurt the stock market. Time marches on.

* * * *

Here is an interesting and almost insane aside on the money situation. Since mid-November, despite the Fed's "intent," the money supply has been careening to new all-time record highs (see chart, courtesy of Indicator Digest, Palisades Park, N.J.). AreMr. Mitchell and the rest of his cohorts on the Fed telling the American people another fairytale regarding the Fed's intention of stopping inflation? Or has the Fed lost control of the money market? It could be a little of both. In large part, the new increase in the money supply has been provided by a rundown in time deposits as money is switched to demand deposits, and, of course, demand deposits form the largest part of the money supply. Thus, the Fed has, to some extent, lost control in their supposed effort to hold back the booming money supply. Also swelling the money supply is the huge influx of foreign funds seeking to invest in U.S. securities. However, foreign purchase of U.S. securities can be a two-way street, and there are now indications that foreigners are cutting back on U.S. security purchases.



CREDIT NOTES: Seven out of every ten cars in the nation are owned by the banks or the finance companies. More than two-thirds of Americans buy cars on credit. Americans borrow $44 billion per year for purchase of cars, pay annual interest of over $2.5 billion. The U.S. is the easiest place on earth to buy a car, and dealers like it that way; it means higher profits.

On January 1 of this year U.S. mortgage rates hit a record of 7.4%, in the West it was 7.65%. At a rate of 7.5% on a $40 thousand house, with $10 thousand down and a thirty year mortgage, the man pays total interest for the thirty years of $36.5 thousand. This is as much interest as the original value of the house. Speaking of the current rate situation, Republican Representative William Widnall of New Jersey stated, ".....this is no longer an effective market rate." He pointed to the 6 and 7 point discounts being charged now in various parts of the nation. "Discounts at such a level, just as they did in the credit crunch of 1966, will dry up the government-insured and guaranteed mortgage programs as insurance company lenders pull out of the market and as sellers of existing houses refuse to see their equity absorbed bu financing costs of the prospective purchases. The resale market will go dead and the new-homes market will be adversely affected as trade-up deals wither away."

GOLD AND POLITICS: The gold hedge play is not dependent merely upon an erosion of the leading currencies and an ultimate raising of the price of gold to cover deficits in balance-of-payments deficits. There is a very definite political play.

Russia has been taking a relatively soft-line with Nixon (so far), as has DeGaulle. Russia has large stockpiles of gold which she is withholding from the market, while DeGaulle has a philosophical commitment to the true gold standard. Thus both Russia and France stand to gain by any official world revaluation of gold.

By the same token, Russia (the most powerful member of the gold bloc) exerts tremendous influence in Asia and particularly in Vietnam. France has major influence in the Middle-East, the next potential world hotspot. The rest of Europe is committed to an ultimate higher price for gold.

The question is, will the Nixon Administration make a deal with France and Russia on a higher price for gold in return for peace in Vietnam and the Middle-East. My own belief, based on what I read and sense, is that such a deal (barring an economic catastrophe which might force a higher price for gold) is probably coming this year.

Taking Vietnam alone, Nixon is aware that as of now it is still Johnson's war. But six months from now if there is no settlement it is going to be Nixon's war. The unspoken price for real cooperation from Russia and France is the price of

less tax money coming in, the Government would then be forced to cover the ensuing deficit with massive issues of bonds, thereby breaking the already tottering bond market. This is in sharp contrast to the thinking that states that any decline in economic activity will automatically put less strain on the money markets, thereby toppling interest rates.

That is the classical approach and it has usually been correct. But it has never been put to the test in a situation such as today's, when our Government is faced with huge and mounting expenses, a still-continuing Vietnam war, a still-rising military budget, and forthcoming grandiose plans for rebuilding the cities and aiding the underpriviledged. It is one thing lowering Government tax receipts when the bond market is healthy and when the Government has control of expenses. It is quite another thing as conditions stand today.

Conclusion: An economic recession, in my opinion, would ultimately bring sky-rocketing interest rates as the Government would be forced to issue large blocks of bonds in an effort to cover its huge built-in expenses.

A second possibility is that Mr. Nixon will not be able, at least immediately, to do anything about the continuing boom. I will not argue with the correctness of this opinion, and, in fact, I will not deny that business may continue up for awhile.

But here too I believe the results are going to lead to trouble. As to the type of trouble, I turn to my economist-friend Eliot Janeway. "Ours is admittedly an unconventional stance," writes Janeway in his latest Janeway Service. "We expect a credit crunch. We do not, however, expect a business slowdown."

Janeway feels that interest rates are fated to continue rising. He believes that the market will rally again, as it sees higher interest rates failing to slow the economy. When the Administration sees that higher interest rates have failed to slow the boom, thinks Janeway, a credit crunch will be tried. This too will fail, and that is the time to watch out.

Janeway writes that the worst of what is happening is not what is happening to prime borrowers, but what is happening to the smaller borrower. Bank money, he says, is already costing non-prime borrowers up to 10%, with no guarantee of renewal of loans. The loss of Certificate of Deposit money is now beginning to bother the banks, and Janeway foresees the banks (under continuing heavy pressure to lend) turning to unload their bond portfolios in an effort to raise cash. Any mass dumping of bank bond portfolios is calculated to smash the bond market to new lows, and this is what Mr. Janeway believes will happen.

In the face of new highs in the now-7% prime rate, in the face of a sinking bond market with corresponding new highs in bond yields, Mr. Janeway then sees the probability of a business slowdown. But first he foresees monetary and interest rate chaos, and I would not care to argue with him. His crystal ball has been mighty good in the past.

Conclusion: Mr. Nixon and the nation will have to "pay their money and take their choice." There is no easy or painless way out of the present dilemma. To present a bit of reverse logic, I somehow doubt that Mr. Nixon understands the full meaning of the current economic puzzle. If he did, if he really did, I wonder why he would be so eager to be President. I believe that the Presidency is going to be a thankless job over the next four years. If Nixon does the "right" thing, he is probably going to be hated. If he goes along with inflation which, for the sake of argument, we will term the "wrong" thing, he is apt to be hated all the more. Good luck, Richard Nixon, you are going to have a tough road ahead.

AND MEANWHILE.....The Federal Reserve Board does seem to be taking a stand against inflation. On January 13 George W. Mitchell (a member of the Fed) conceded that "we were wrong" to "ease up a little" in monetary policy after Congress passed the surtax last June. However, he stated, the Fed now "means business in breaking the inflationary psychology that has developed." He added that ".....economic growth might be retarded for a year or more before the needed change in climate takes place," and that "without a doubt" this will result in some unemployment.

Asked about this latest attempt at fine-tuning, Mitchell said, "I think we can get things under control without pushing the country into an actual slump. But there is an element of risk." Regarding the 1967 attempt to moderate the restrictive monetary policy following the surtax, Mitchell said that the Fed thought the surtax would quickly put a damper on inflation. "It turns out we were wrong," he added. "We were not any smarter than anybody else."

My own feeling is that if the economy does start to sag, the Fed will first greet the sag with glee, then if the sag turns into a recession, the Fed's glee will turn to consternation. The big question, of course, is whether the Fed or anyone

gold. Therefore, I expect international politics to be the catalyst for a gold price hike during the next six months.

As far as the negotiation, I feel we have been watching the big stall. This little clip from the January 24 Wall Street Journal is obvious in its implications. Hanoi is far from "giving up," she does not have to give up. The real deals have yet to be made, and one of them is going to be gold.

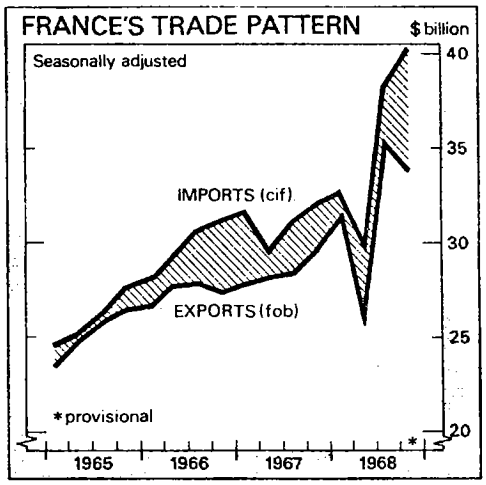
Conclusion: Ignore the periodic little shakeouts in the gold shares and the price of gold. Watch the larger overall trend in these two indicators. So far, despite all official disclaimers, the trend is up.

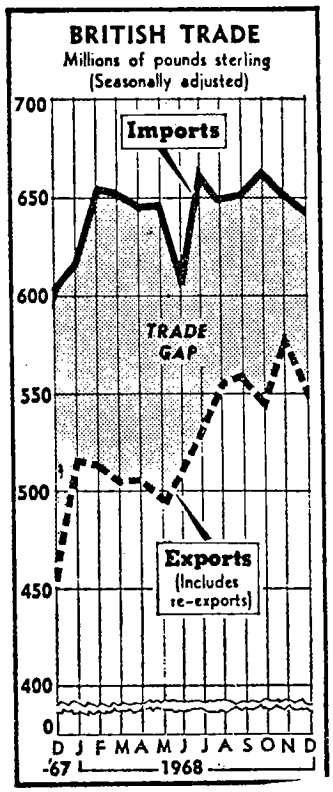
HANOI ESCAPES serious harm to its war potential, Pentagon analysts find.

Their studies conclude that manpower losses only slightly impede the North's ability to replenish fighting units in the South, maintain its primitive war production machine. The analysts figure that even a 1969 repeat of 1968's losses—about 240,000 deaths—wouldn't hurt Hanoi's capabilities significantly.

If peace comes in 1969, North Vietnam's manpower reserves at year-end would exceed those of the early 1960s, according to the studies. The main explanation: Population growth has exceeded expectations. The North now has 485,000 in its regular armed forces, plus 600,000 in other units.

GAPS: "It is a sickening thought that once again Britain must live in dread of the next set of trade figures," said the London Economist last week. "December's outcome.....was very disappointing." As seen on the chart, the British deficit (including the usual monthly excuses, goes on. "December's figures now only make the future look more anxious," continued the Economist, "but they also put the finishing touches to an awful trading year." What more can I add?





In France the situation is deteriorating at a more rapid rate. The French trade gap widened spectacularly between the third and fourth quarters of 1968, with the ratio of exports to imports dropping from 95% to 81%.

Obviously, the current state of affairs cannot continue indefinitely in either nation. They will have to become more competitive in their export pricing, thus pushing up export sales, or they will have to slow down on their imports via a recession— or they will have to ultimately devalue their currencies.

I am a firm believer that the trend will continue until proved otherwise. On this basis, I would bet on forthcoming devaluation in both Britain and France. If so, forthcoming monetary crisis can be again expected, probably during 1969. Which is why I advocate the continued holding of gold mining shares. The two charts shown here imply that gold shares should continue to be held. And I do not like fighting trends, whether they are stock trends or trade balance trends.

STOCKS: Pictured here are three charts which are typical of the retail stocks in general at this time (charts courtesy of Quote Digest, 110 N. Lorrain, Wichita, Kansas.), it takes little imagination to see that the market is becoming disillusioned with the forthcoming consumer sales picture, and the retail stocks are topping out accordingly. Whether tight money alone is causing this picture I do not know. But I would guess that a decline in retail sales is looming over the horizon. This will be something to reckon with in 1969.